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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1929.

No. 250

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

OX FIBRE BRUSH COMPANY,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

ANSWER TO PETITION FOR WRIT OF CERTIORARI.

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ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

32 Fed. (2d) 42.

ANSWER TO PETITION FOR WRIT OF CERTIORARI.

Respondent respectfully submits that this is not a case for *certiorari*, for the following reasons:—

1. **Uniformity of decision is maintained by upholding the decision of the Court of Appeals.**

The decision below was correct and was in accordance with the rulings of the Bureau of Internal Revenue, with the decisions of the Board of Tax Appeals, and with the decisions of the courts.

(The one court decision which petitioner relies upon as the exception, and therefore, as creating a conflict in the Courts of Appeal, we believe, and shall show, is not an exception.)

2. **Public Importance is not Involved.**

The question sought to be raised is not so obscure, complicated or important as to require further review. *Magnum Import Co.* v. *Coty*, 262 U. S. 159, 163, is in point.

3. **The suggested question is not necessarily involved.**

The question sought to be raised is not necessarily or properly presented by this record.

STATEMENT.

This case arose because the Commissioner of Internal Revenue disallowed as deductions from taxable income of the Ox Fibre Brush Co., respondent, for the year 1920, two amounts of $24,000, accrued and paid in that year as salary to its President and Treasurer, respectively.

The Company appealed from this disallowance (and his proposed additional assessment) to the Board of Tax Appeals, which sustained the Commissioner. Thereupon the Company appealed to the Court of Appeals for the Fourth Circuit; and that Court reversed and held erroneous the Commissioner's disallowance of the payments and sustained them as proper deductions. (*Ox Fibre Brush Co.* v. *Blair Comr., etc.*, 32 Fed. (2d) Sec. 42.)

The Petition admits (pp. 2, 5) that the above amounts were in fact paid for services actually rendered, and not as a distribution of dividends or earnings, and also that the amounts were reasonable.

The officers in question, together with their families, owned only 36% of the stock of the corporation. (32 Fed. 2d, p. 44, 2d column.)

The resolution of the Board of Directors, of 1920, stated that the amount to be paid was "* * * as extra compensation for his past services to this Company."

No doubt as to the good faith of the transaction is intimated by the Petition; and the Court of Appeals expressly

finds that "the company's board of directors unanimously declared *in good faith* that the services rendered were worth the additional compensation." (32 Fed. (2d) p. 48.)

If the compensation in question be considered as salary for the year 1920 alone, it is entirely in line with and in reasonable proportion to the services rendered, business done and earnings accrued for that year.

This was pointed out in the opinion of the Circuit Court of Appeals (R. 56, 32 F. (2d) 42, 48) 32 Fed. (2d) pp. 43-4, where the amounts of annual earnings, expenses and salaries are classified, and the salaries for 1920 are shown to be 5.8 per cent of the gross income; and "the net income in 1920, "namely $158,753.67, after deduction of all expenses includ-"ing officers' salaries represented a return of 21.13 per cent "on invested capital of $751,038.31 as determined by the "Commissioner of Internal Revenue for that year."

Memorandum of Argument.

1. The Decisions of the Court of Appeals Is in Accord with the Uniform Previous Decisions.

A corporate taxpayer, in calculating its net taxable income, may deduct from gross income "a reasonable allowance for salaries or other compensation for personal services actually rendered" to the corporation (1918 Revenue Act, Sec. 234 (*a*) (1)).

(Distributions of corporate profits, whether by formal dividend or otherwise, are not deductible.)

It is submitted that upon the facts the sole test of the corporation's right to deduct these payments is that the amounts in question be reasonable for services actually rendered, and not a distribution of profits.

The amounts of these compensations were not and could not be accrued until the year 1920. There had been no de-

termination to pay any such additional compensation prior to the year 1920, therefore no liability to pay; and necessarily, the amounts could not have been accrued and deducted prior to 1920.

(Opinion, C. C. A. R. 53, 32 Fed. 2d, p. 46):

> "But a salary can neither be 'incurred,' nor can it have 'accrued' until the payor's liability for the same has been fixed, that is, until the company, in the present case, has voted it payable."

The Board of Tax Appeals in this case and the Circuit Court of Appeals, both held that the salaries were accrued in 1920.

A. Assuming that the compensation in question was for services rendered prior to and during 1920, it is clearly deductible as the decisions uniformly hold.

The obligation to pay the compensation was first incurred in 1920, and was an accrual in 1920, and was, therefore, in accordance with the accrual method of bookkeeping pursued by respondent. The money has in fact been paid out by respondent for services and not as distribution of profit; and unless it is allowed as a deduction, the net income for that year will not be truly reflected in accordance with Section 212 of the Revenue Act of 1918.

The provisions of the statute allowing such deductions (Section 234 (*a*) (1) of the Revenue Act of 1918) is as follows:

> "All ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, * * *."

The section does not read, "actually rendered *during the taxable year.*" The statute imposes no such restriction.

In the very nature of things, payments for services are practically always for past services. The Board of Tax Appeals has repeatedly held that additional compensation for services rendered in prior years is deductible in the year in which the compensation is voted and paid. This provides a simple, workable rule. *Flint River Brick Co.*, (2 Bd. Tax Ap. 31); *Lihue Plantation Co.*, (2 B. T. A. 740); *Van de Kamps Holland Dutch Butchers*, (2 B. T. A. 1247); *Arter Paint & Glass Co.*, (2 B. T. A. 1256); *Washington Cadillac Co.*, (2 B. T. A. 844). And, we quote from the opinion of Solicitor Gregg, General Counsel for Bureau of Internal Revenue: "The Commissioner has acquiesced in all these decisions (C. B. IV-2, 2, and C. B. V-1, 4, 6, 1, 6)."

Int. Rev. Bulletin Cum. Bul. VI-1 (January—June, 1927, p. 207.)

It is the Commissioner's refusal to acquiesce in the like ruling in the instant case that breaks the uniformity and the decision of the Court of Appeals that restores it.

To introduce the year the services were rendered as a third element in the test of deductibility would add a serious complication to the tax laws,—and one not provided by the statute. The Commissioner of Internal Revenue acquiesced in all of these decisions of the Board (1925 C. B. IV-1, 2, 3; 1925 C. B. IV-2, 2; 1926 C. B. V-1, 4, 6, 1, 6) and therefore issued a formal ruling to that effect. (*G. C. M.* 941, *Internal Revenue Cumulative Bulletin, Vol.* VI-1, p. 205 (1927)). We quote from pages 207-8:

"Summarizing the foregoing conclusions and specifically answering the three inquiries submitted, it is the opinion of this office that—

(1) In view of the decisions of the Board of Tax Appeals cited by the taxpayer and of the other decisions of the Board involving the same question in which the Commissioner has acquiesced, the additional compensation voted and paid by the taxpayer in its fiscal year

1918 to its president for services performed in 1917 and in prior years is deductible as an expense of the fiscal year 1918;

(2) The ruling in Advisory Tax Board Memorandum 86 that additional compensation voted and paid subsequent to the close of the year in which the services were rendered is not deductible in any year has been modified by the acquiescence of the Commissioner in decisions of the Board of Tax Appeals which hold contrary thereto; * * *."

For Board cases to the same effect decided subsequent to G. C. M. 941, see *Rock Island Sash & Door Works* v. *Commissioner of Internal Revenue,* 13 B. T. A. 635, and cases cited; *Commercial Electrical Supply Company* v. *Commissioner of Internal Revenue,* 8 B. T. A. 986. See also *Rocebaix Mills, Inc.* v. *Commissioner of Internal Revenue,* 7 B. T. A. 878; *Vaughan & Barnes, Inc.* v. *Commissioner of Internal Revenue,* 6 B. T. A. 1279.

We respectfully submit that all of the court decisions are to the same effect.

For a decision holding in accord with the statement of the Circuit Court of Appeals for the Fourth Circuit in the case at bar that compensation for a prior year is deductible in the year in which it is incurred, see *S. Naitove & Co., Inc.* v. *Commissioner of Internal Revenue,* 32 F. (2d) 949, a decision of the Court of Appeals of the District of Columbia affirming a decision of the Board of Tax Appeals which affirmed a determination of the Commissioner of Internal Revenue. Concerning the accrual of additional compensation, the Court of Appeals, at pp. 950 and 951, said:

"Construing the provisions of the income tax law here involved, we are of the opinion that under the accrual system of accounting income may be said to be accrued when it is definitely received, and that likewise liabilities or expenses will be considered to have accrued only when the events have occurred from which liability or

> expense can be determined and fixed, even though payment is not yet due."

For other decisions to the same effect, see *United States v. Block & Kohner Mercantile Co.*, (D. C. E. D. Mo.) 33 F. (2d) 196; and *Wunderle* v. *McCaughn*, (D. C. E. D. Pa.), filed June 5, 1929 (Com. Cl. H. 1929, III Fed. Tax Service, pp. 8652-4), where the court, in discussing the deductibility of compensation allowed in a year subsequent to that in which the services were rendered, said:

> "The defendant (the Collector of Internal Revenue) raises the question that, if it is a bonus, it is not allowable for the year in which it was charged off, but must be prorated over the years during which the services were rendered. This would be true if it had been payable as the result of some legal obligation or promise incurred or made in connection with the employment, but is not true where, as in this case, there is no such obligation existing."

B. The Bogle case not an exception to this uniformity.

Petitioner relies upon the case of *W. S. Bogle & Co.* v. *Commissioner*, 26 F. (2d) 771, C. C. A., 7th Circuit, as contrary, and, as therefore raising a conflict in the Circuit Courts of Appeals. The Circuit Court of Appeals below distinguished the *Bogle* case because of the fact that the court in the *Bogle* case spoke of the salary for previous years as "fixed and *fully* paid * * *, implying, as it would seem, that "the additional compensation rendered the total salary "unreasonable and excessive." Moreover, there was no holding in the *Bogle* case that the additional allowances were reasonable;—while in this case the Court of Appeals devotes a page of its opinion (p. 43) to the facts, and another (pp. 47-8) to the principles applicable thereto, showing that the allowances were reasonable, and that "no testimony whatever was offered on the part of the Commissioner in rebuttal."

The regulations promulgated by the Treasury Department under this provision have adopted this interpretation of the

statute. Article 561 of Regulations 45, under the Revenue Act of 1918, refers to Article 106, which reads, in part, as follows:

> "Compensation for personal Services.—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. *The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.*" (Italics ours.)

This provision has remained unchanged through all the regulations. See Article 106 of Regulations 62 under the Revenue Act of 1921, Regulations 65 under the Revenue Act of 1924 and Regulations 69 under the Revenue Act of 1926, and Article 126 of Regulations 74 under the Revenue Act of 1928. Article 108 of Regulations 45 provides:

> "*Bonuses to Employees*—Gifts or bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are considered gratuities and are not deductible from gross income."

Aside from certain slight changes in wording, this article has also remained the same through all the regulations. See Article 108 of Regulations 62, Regulations 65 and Regulations 69, and Article 128 of Regulations 74.

It is matter of common knowledge that bonuses often are voted and paid after the close of the taxable year. The regulation does not restrict the deduction to bonuses voted and paid during the taxable year. This further confirms the interpretation given the statute by the Court of Appeals.

We respectfully suggest, therefore, that reasonable compensation, *both paid and incurred in the year* 1920, for services actually rendered, even though those services or part of them were rendered prior to 1920, is deductible in 1920.

The previous rulings of the Board of Tax Appeals are uniformly to that effect. These rulings have been acquiesced in and approved by the Bureau of Internal Revenue.

The decisions of the courts are uniformly to that effect. We do not think the *Bogle* case is an exception. If so, it is contrary to the overwhelming weight of administrative precedent and judicial decisions.

There is no distortion of income, and there is no inconsistency with the expressions of this Court in the *Anderson* case.

The Circuit Court of Appeals pointed out the distinction between this case and the case of *United States* v. *Anderson*, 269 U. S. 422. In the *Anderson* case, the munitions tax accrued in 1916 simultaneously with the earnings. The tax liability arose automatically with the earning of the income. In the case at bar, there was no liability until the compensation was authorized and voted by the Board of Directors. Consequently, there was no right to deduct these payments in any year prior to 1920.

2. Public importance is not involved.

The suggestions *contra* are based on the allegation that the decision here conflicts with that in the *Bogle* case, and hence it is alleged *contra* that "the Commissioner is unable to determine the proper principle to be applied." (Petition, p. 7.)

But that alleged conflict does not exist. If any conflict did exist it would be between the Bogle decision standing alone and the several decisions followed by the Court of Appeals in this case.

The *Bogle* case was cited to the court below in this respondent's brief (pp. 10, 25) as in harmony with the others. It was not mentioned in Petitioner's brief there. Such suggestion of conflict comes now for the first time. The Bogle decision is adequately distinguished by the court below (and by the distinctions heretofore indicated herein) as not conflicting either with the other decisions or with the decision herein; and the seeming difference indicated *contra* is not so plain, direct or vital as to constitute a matter of public importance requiring review and correction by this court of last resort.

The suggested difficulty of the Commissioner will readily be avoided by his pursuing the same course which he has pursued in the previous cases, viz., by continuing to acquiesce in the decision, as recited in *Internal Revenue Cumulative Bulletin*, Vol. VI-1, p. 205.

3. **The suggested question is not necessarily involved.**

We respectfully suggest that the question sought to be raised by petitioner is not necessarily or properly presented by the record. The Board of Tax Appeals held not only that the compensation in question was accrued in 1920 but that it was for services in 1920. No error was assigned by petitioner to the holding of the Board of Tax Appeals that the compensation was for the year 1920.

The Board of Tax Appeals held that the additional compensation was unreasonable in amount because it exceeded the amounts paid in prior years. The Circuit Court of Appeals reversed the Board of Tax Appeals in this respect, and held that the compensation was reasonable. Petitioner admits, at Page 5, that the payments were reasonable, based on services performed in prior years. The decision of the Circuit Court of Appeals and this admission, although qualified, eliminates the question of reasonableness from the case, leaving the decision of the Circuit Court of Appeals final in this respect.

It must be accepted, then, that the compensation in this case was *reasonable*. The arguments, therefore, on Pages 10 and 11 of petitioner's brief, that if the decision is sound, a taxpayer may arbitrarily shift expenses, is inapplicable to this case, where the action of the Board of Directors was reasonable. It would be more appropriate for petitioner to raise that issue where the facts show arbitrariness instead of the case where the *facts* show, and the decision finds, reasonableness.

We do not think that the question sought to be raised by petitioner is properly before the Court.

CONCLUSION.

Since the construction of the statute by the Circuit Court of Appeals for the Fourth Circuit in the case at bar gives the reasonable and proper interpretation to Section 234 (*a*) (1) of the Revenue Act of 1918; since the same interpretation has been given to this section by every court which has had the question before it,—by the Board of Tax Appeals and by the Bureau of Internal Revenue, itself; since there is no conflict of decisions of Circuit Courts of Appeals; and since, in view of the state of the record, the statement that the compensation was for services for prior years was unnecessary to the decision of the case, we respectfully submit that the petition for *certiorari* should be denied.

Respectfully submitted,

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